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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-263

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

IDAHO POWER COMPANY,

Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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INDEX

	PAGE
Question Presented	1
Statutes Involved	1
Statement of the Case	2
ARGUMENT	4
I. The decision of the Court of Appeals does not warrant review by the Supreme Court because it is clearly correct	4
II. The deduction for depreciation is to be allowed in accordance with the intention of Congress as manifested in the Internal Revenue Code	6
III. The decision of the Court of Appeals does not warrant review because there is no real conflict and the issue involved is not of sufficient importance	10
CONCLUSION	14

CITATIONS

Cases:

American Automobile Association v. *United States*, 367 U.S. 687 (1961)	6
Breeze Corporations, Inc. v. *United States*, 117 F. Supp. 404 (Ct. Cl., 1954)	6
Calafut, Stanley G. v. *Commissioner of Internal Revenue*, T.C. Memo. 1964-239, reported unofficially at 23 T.C.M. 1431 (1964)	5

PAGE

Gordon, Maurice S. v. *Commissioner of Internal Revenue*, 37 T.C. 986 (1962) 5

Hagen Advertising Displays, Inc. v. *Commissioner of Internal Revenue*, 407 F.2d 1105 (6th Cir., 1969) 6

Layne & Bowler Corporation v. *Western Well Works, Inc.*, 261 U.S. 387 (1923) 10

Marquardt Corporation v. *Commissioner of Internal Revenue*, 39 T.C. 443 (1962), acq. and nonacq. 1965-2 C.B. 6, 7 6

Massey Motors, Inc. v. *United States*, 364 U.S. 92 (1960) 5

Mitchell, Clinton H. v. *Commissioner of Internal Revenue*, 42 T.C. 953 (1964), acq. 1965-2 C.B. 6 5

National Labor Relations Board v. *Pittsburgh Steamship Company*, 340 U.S. 498 (1951) 10

Orr, John Herbert v. *United States*, 343 F.2d 553 (5th Cir., 1965) 5

Schlude, Mark E. v. *Commissioner of Internal Revenue*, 372 U.S. 128 (1963) 6

Southern Natural Gas Company v. *United States*, 412 F.2d 1222 (Ct. Cl., 1969) 10, 11, 12, 13

State Mutual Life Assurance Company of Worcester v. *Commissioner of Internal Revenue*, 246 F.2d 319 (1st Cir., 1957) 5

United States v. *Charles A. Ludey*, 274 U.S. 295 (1927) 5

PAGE

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 163 ..... 10, 11

Section 164 ..... 10, 11

Section 167 ..... 4, 8, 11

Section 263 ..... 4, 11, 13

Section 446 13

Miscellaneous:

House Report No. 1337, 83d Cong., 2d Sess., 1954 .... 7, 8, 9

Senate Report 1622, 83d Cong., 2d Sess., 1954 8

Revenue Procedure 70-24, 1970-2 C.B. 505 5

Revenue Procedure 64-15, 1964-1 C.B. (Part 1) 676 5

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Question Presented

When a taxpayer uses its depreciable equipment to construct other depreciable properties for use in its trade or business should depreciation on the equipment be deducted over its own useful life under section 167 of the Internal Revenue Code of 1954 or capitalized under section 263 of the Code and deducted over the useful lives of the properties constructed?

Statutes Involved

Sections 161, 167 and 263 of the Internal Revenue Code of 1954, 26 U.S.C. 161, 167 and 263, provide in pertinent part as follows:

> Section 161. In computing taxable income * * *, there shall be allowed as deductions the items specified in

this part [sections 161 through 188], subject to the exceptions provided in Part IX (sec. 261 and following, relating to items not deductible).

Section 167(a). There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business * * *.

Section 263(a). No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) expenditures by farmers for clearing land deductible under section 182. * * *

Statement of the Case

This case concerns deficiencies in United States income taxes determined by the Commissioner of Internal Revenue against Idaho Power Company for the years 1962 and 1963. Idaho Power Company is a public utility engaged in the production, transmission, distribution and sale of electric energy. The taxpayer has additions to its properties constructed by others under contracts and also constructs such additions with its own employees and equipment. During

the years 1962 and 1963, taxpayer owned transportation equipment including passenger cars, various types of trucks, power-operated equipment and trailers which were used for taxpayer's operations and maintenance and for construction of taxpayer's facilities. Communications equipment, such as radios, was affixed to the transportation equipment and used in the operation of such transportation equipment.

This equipment was depreciated for tax purposes over a composite life of 10 years. The facilities which such equipment was in part used to construct had useful lives of 30 years or longer.

Depreciation on the transportation equipment to the extent used in the construction of capital assets was charged on taxpayer's books to the assets so constructed in accordance with accounting procedures prescribed by the Federal Power Commission which have been adopted by the Idaho Public Utilities Commission.

For tax purposes, to the extent the transportation equipment was used in construction of capital assets taxpayer capitalized all costs of operating and maintaining such equipment and deducted currently pension contributions, social security taxes, motor vehicle taxes and depreciation.

The Commissioner of Internal Revenue accepted this tax treatment with one exception. The Commissioner disallowed and capitalized deductions for depreciation on taxpayer's transportation equipment to the extent that such equipment was used in construction of capital assets and allowed a deduction for depreciation of the amounts so capitalized over the useful lives of the properties constructed. The action of the Commissioner of Internal Rev-

enue was upheld by the United States Tax Court; *Idaho Power Company* v. *Commissioner of Internal Revenue*, Docket No. 4012-67, T. C. Memo Decision 1970-83, April 13, 1970.

The United States Court of Appeals for the Ninth Circuit reversed the Tax Court and held that depreciation on the transportation equipment should be treated as a current deduction under section 167 of the Code; *Idaho Power Company* v. *Commissioner of Internal Revenue*, 477 F.2d 688 (9th Cir., 1973).

ARGUMENT

I.

The decision of the Court of Appeals does not warrant review by the Supreme Court because it is clearly correct.

The decision below, holding that depreciation on taxpayer's transportation equipment was a current deduction, carefully analyzed and correctly applied the provisions of the Internal Revenue Code of 1954 and is so clearly correct that it should not be reviewed by the Supreme Court. This decision initially determined that the taxpayer's equipment was depreciable under section 167 of the Internal Revenue Code of 1954. The Court then analyzed section 263 of the Code and determined that this section did not require capitalization of depreciation on taxpayer's equipment. This interpretation is clearly correct.

Section 263 requires capitalization only of an "amount paid out" or of "expenditures". Depreciation is clearly not an "amount paid out" or an "expenditure". The Courts

and the Commissioner of Internal Revenue have consistently taken the position that depreciation is not an "amount paid out" or "expenditure" in the context of the deductions for charitable contributions and medical expenses and in similar situations. *John Herbert Orr* v. *United States*, 343 F.2d 553 (5th Cir., 1965); *Clinton H. Mitchell* v. *Commissioner of Internal Revenue*, 42 T.C. 953 (1964), acq. 1965-2 C.B. 6; *Maurice S. Gordon* v. *Commissioner of Internal Revenue*, 37 T.C. 986 (1962); *Stanley G. Calafut* v. *Commissioner of Internal Revenue*, T.C. Memo. 1964-239, reported unofficially at 23 T.C.M. 1431 (1964); Revenue Procedure 70-24, 1970-2 C.B. 505 and Revenue Procedure 64-15, 1964-1 C.B. (Part 1) 676; *cf. Massey Motors, Inc.* v. *United States*, 364 U.S. 92 (1960); *United States* v. *Charles A. Ludey*, 274 U.S. 295 (1927); and *State Mutual Life Assurance Company of Worcester* v. *Commissioner of Internal Revenue*, 246 F.2d 319 (1st Cir., 1957).

The Court of Appeals did not base its decision on the principles of the cash method of accounting but instead applied the statute as enacted by Congress and held that section 263 requires capitalization only of an "amount paid out" and "expenditures" and that depreciation is neither. It is submitted that this determination is so clearly correct that it does not warrant review by this Court.

II.

The deduction for depreciation is to be allowed in accordance with the intention of Congress as manifested in the Internal Revenue Code.

It is fundamental to taxation that the allowance of deductions to a taxpayer is governed by the intention of Congress as manifested in the Internal Revenue Code and not by general principles of accounting.[1] This concept has clearly been recognized by the Commissioner of Internal Revenue in the instant case in that there has been no challenge to taxpayer's deductions for pension contributions, social security taxes and motor vehicle taxes associated with the construction of capital assets. In an accounting sense the depreciation at issue is no more or less a part of the costs of construction of capital assets. Just as in the case of these other deductions, Congress has provided for the current deduction of depreciation and has not required its capitalization in accordance with some general accounting concept. It is submitted that the allowance for depreciation in respect to taxpayer's equipment is to be governed by the intention of Congress as manifested in the statute.

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[1] While under general accounting principles it may be proper to match items of income with related expenses, this principle of matching is clearly not controlling for tax purposes. *Mark E. Schlude* v. *Commissioner of Internal Revenue*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687 (1961); *Hagen Advertising Displays, Inc.* v. *Commissioner of Internal Revenue*, 407 F.2d 1105 (6th Cir., 1969); *Breeze Corporations, Inc.* v. *United States*, 117 F. Supp. 404 (Ct. Cl., 1954); and *Marquardt Corporation* v. *Commissioner of Internal Revenue*, 39 T.C. 443 (1962), acq. and nonacq. on other issues 1965-2 C.B. 6, 7.

Congress has recognized that accelerated cash flow through the allowance for depreciation is essential to the modernization and growth in the productive capacity of United States industries and is necessary in order to enable United States industries to meet foreign competition. In adopting the Internal Revenue Code of 1954 Congress recognized that the depreciation policies under the 1939 Code failed to encourage the replacement of obsolete equipment and did not encourage growth in productive capacity. The extent of this problem was indicated in the report of the Committee on Ways and Means which contains the following statement:

> "There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment." (House Report No. 1337, 83d Cong., 2d Sess., p. 22)

Recognizing this problem Congress in enacting the Internal Revenue Code of 1954 provided more liberal depreciation allowances in the form of accelerated depreciation. It is clear that the purpose underlying such liberalized depreciation allowances was to encourage the modernization of plant equipment and to increase the productive capacity of United States industries. The report of the Committee on Ways and Means clearly sets forth this purpose in the following statement:

"More liberal depreciation allowances are anticipated to have far reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax writeoff would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living."[2] (House Report No. 1337, 83d Cong., 2d Sess., p. 24)

Beginning with the adoption of the 1954 Code both Congress and the Department of the Treasury, having recognized the importance of rapid cost recovery through depreciation as a means for increasing productive capacity and meeting foreign competition, have provided for methods of depreciation which emphasize the rapid recovery of the cost of an asset in order to provide a taxpayer with an adequate cash flow to purchase or construct new equipment or facilities. At section 167(b), subject to certain limitations, a taxpayer is permitted to compute depreciation not only under the straight-line method of depreciation but also the double declining-balance method and by the sum-of-the-years' digits method. These two methods result in much larger depreciation deductions in the early portion of the life of a capital asset than does the straight-line method. This fact was explained in the report of the Committee on Ways and Means in adopting the Internal Revenue Code of 1954 in the following statement:

[2] The report of the Committee on Finance contains an identical statement; Senate Report 1622, 83d Cong., 2d Sess., p. 26.

> " . . . The depreciation allowances under this method, therefore, are considerably larger in the early years of the life of a property than those resulting from the straight-line method. The declining balance method at twice the appropriate straight-line rate will write off approximately 40 percent of the cost of an asset in the first quarter of its service life and two-thirds of the cost in the first half of its life." (House Report No. 1337, 83d Cong., 2d Sess., p. 23)

Clearly Congress in enacting the Internal Revenue Code of 1954 recognized the concept of rapid cost recovery as a means of encouraging plant modernization and growth in productive capacity and specifically provided for methods of depreciation under which most of the cost of a capital asset was recovered within a relatively brief period of time in order to permit a taxpayer to purchase or construct additional facilities.

The decision of the Court of Appeals in this case is consistent with the cost recovery concept underlying the tax depreciation policy of Congress. This decision permits the taxpayer to deduct depreciation on equipment computed in accordance with the life established for such equipment. In this manner through the tax-free recovery of the cost of the equipment, the taxpayer is able to replace such equipment or otherwise increase its productive capacity.

Furthermore, capitalization, or the deferral of depreciation deductions, in an attempt to match such deductions against income earned by the property would be completely inconsistent with the above described Congressional intent. Capitalization of depreciation in the instant case would result in a situation where the entire cost of taxpayer's equipment would not be recovered until 40 years after the

equipment was acquired or 30 years after the end of its useful life. This result would not only deter modernization of, and increases in, plant capacity but would deter the mere replacement of existing capacity.[3]

III.

The decision of the Court of Appeals does not warrant review because there is no real conflict and the issue involved is not of sufficient importance.

This Court has consistently adhered to the policy of granting a Writ of Certiorari only where there is a "real and embarrassing conflict of opinion and authority between the circuit courts of appeal"; *National Labor Relations Board* v. *Pittsburgh Steamship Company,* 340 U.S. 498 (1951); *Layne & Bowler Corporation* v. *Western Well Works, Inc.,* 261 U.S. 387 (1923). In the instant case the Commissioner of Internal Revenue asserts that a conflict exists between the decision below and the decision in *Southern Natural Gas Company* v. *United States,* 412 F.2d 1222 (Ct. Cl., 1969).

In *Southern Natural Gas Company* v. *United States,* the United States Court of Claims merely adopted the decision of its Trial Commissioner. Neither the taxpayer nor the

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[3] It is suggested (Petition, p. 7, n. 6) that capitalization would achieve a "tax parity" between taxpayers constructing their own facilities and those hiring contractors. The Internal Revenue Code has never attempted to arrive at such a balance. For example, a contractor's charges that must be capitalized would include many items which would not be capitalized by a taxpayer constructing assets for its own use, such as interest deductible under section 163, taxes deductible under section 164, a profit element and income taxes on profits. It is clear that depreciation should not be capitalized to create an illusory parity, but instead the express provisions of the Code allowing a deduction for depreciation should be followed.

United States took exception to the Trial Commissioner's finding on the issue involved here.

It is submitted that this decision of the Trial Commissioner as adopted by the Court of Claims is based on three so clearly erroneous assumptions that there is no "real and embarrassing" conflict between the decision in the *Southern Natural Gas* case and the decision below.

First, the Trial Commissioner viewed the issue as one of carving out a special exception to the law for depreciation, stating "No reason is apparent for carving out a special exemption for depreciation." (412 F.2d 1222, 1265) It is clear that the allowance of a deduction for depreciation on equipment used to construct and capital assets does not involve carving out a special exception, but instead is an application of the express language of the Internal Revenue Code as adopted by Congress. It is quite clear that the generalization that all costs of creation of an asset are to be capitalized for tax purposes is not in accordance with the provisions of the Internal Revenue Code. Specific examples of costs not capitalized are the deductions for interest and state and local taxes in sections 163 and 164 (26 U.S.C. 163, 164) of the Code. Similarly, Congress expressly provided for the deduction of a reasonable allowance for depreciation in section 167 and required capitalization under section 263 only of amounts "paid out" or "expenditures". It is submitted that the Trial Commissioner's decision so clearly ignored the express statutory language that there is no real conflict between his decision and that of the Court below.

The second erroneous assumption of the Trial Commissioner was that there would be a double recovery of costs if a taxpayer was permitted to deduct depreciation on

equipment used to construct its own assets, first when the depreciation is deducted and second when the constructed asset is sold (412 F.2d 1222, 1265). As pointed out by the Court below this assumption is "patently incorrect" (477 F.2d 688, 695). If a taxpayer is permitted to deduct depreciation on equipment used to construct a capital asset the basis of the capital asset would not include the depreciation so deducted. Although the taxpayer may be able to sell the property constructed at the same price regardless of whether it constructed property itself or had the property constructed for it, in the former case it would have a larger gain for income tax purposes upon which tax must be paid. From a federal income tax point of view there appears to be no possibility of a double recovery of cost.

The third erroneous assumption of the Trial Commissioner was that if the taxpayer was permitted to deduct depreciation on equipment used by the taxpayer to construct its own assets such assets would be without a tax basis (412 F.2d 1222, 1266). It is submitted that this fear of the Trial Commissioner is without foundation. Unquestionably the Internal Revenue Code permits a deduction of interest and state and local taxes which a taxpayer would not have incurred but for the fact he is engaged in the construction of an asset for his own use. However, the existence of this type of deduction does not leave the taxpayer without a basis for self-constructed assets. Likewise the allowance of a deduction for depreciation of equipment used by a taxpayer to construct an asset for his own use would not lead to the inference that an expenditure incurred in constructing such an asset may be deducted rather than capitalized. A taxpayer's expenditures for labor, materials and other items would be capitalized for

the reason that they fall directly within the scope of section 263 which provides for the capitalization of amounts "paid out" or "expenditures" for capital assets.

It is submitted that the decision of the Trial Commissioner in the *Southern Natural Gas* case was based on three so clearly erroneous assumptions that there is no "real and embarrassing" conflict between the decision below and the decision in the *Southern Natural Gas* case.

It is further submitted that the question presented by this case is not of sufficient importance to warrant review by this Court. The question presented does not involve a taxpayer's ultimate tax liability, but only the timing of such liability. The question is merely whether the taxpayer is entitled to deduct the cost of equipment over the life of the equipment or whether the taxpayer must recover the cost of the equipment over the life of both the equipment and the self-constructed assets.[4] This issue is not of sufficient importance for this Court to review.

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[4] While the Petition (pages 4 and 5) suggests that acceptance of the decision below could result in revenue losses from the electric utility industry of approximately $40,000,000 to be recovered in subsequent years and potentially hundreds of millions of dollars, likewise to be recovered in subsequent years, the magnitude of such figures is clearly misleading. After stating that the taxpayers which would be affected by the decision below are the electric utility industry, railroads, other utilities and major industrial corporations, the Petition states ". . . such taxpayers, in filing their returns, have generally followed a method of depreciation accounting similar to that urged by the Commissioner in this case." From the foregoing statement it is apparent that for such other taxpayers to use the method of depreciation accounting followed by Idaho Power Company, and upheld by the Court of Appeals, a change in method of accounting requiring the Commissioner's consent would be necessary; 26 U.S.C. 446(e). Therefore, there would be no substantial likelihood of large revenue deferrals unless the Commissioner consented.

CONCLUSION

For the foregoing reasons the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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